



Statement of the

Association for Financial Professionals

before the

U.S. House of Representatives
Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
Representative Spencer Bachus (R-AL), Chairman

Tuesday, March 13, 2001
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STATEMENT OF THE ASSOCIATION FOR FINANCIAL PROFESSIONALS BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE
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Good Afternoon Mr. Chairman and members of the Subcommittee on Financial Institutions and Consumer Credit. The Association of Financial Professionals (AFP) welcomes the opportunity to offer our views on legislation for the payment of interest on business checking accounts.

AFP represents almost 15,000 treasury and finance professionals who, on behalf of over 5,000 corporations and other organizations, are significant participants in the nation's payments systems and capital markets. Many of our members are responsible for their organizations' banking relationships, payments activities, short-term investments, and general cash management functions. Organizations represented by our members are drawn generally from both the Fortune 1000 and middle market companies—with fifty percent of our members employed by organizations with annual sales under 1 billion dollars. They are significant users of financial services, and specifically sweeps accounts offered by banks, and they have an active interest and sizeable stake in any efforts by the 107th Congress to modernize business checking by ending the prohibition against interest payments.

Since business checking relief legislation has not yet been introduced in the House of Representatives during this session, we understand that the assumptions for discussion at these hearings are that a business checking relief bill would allow:

- Depository institutions the option to pay interest on business checking accounts. The effective date for this option however would be at least two years after the bill is passed. In the interim, banks could raise the six Money Market Deposit Accounts (MMDA) transfers per month limit to 24, almost immediately;
- Payment of interest on depository institutions' balances required to be held on reserve at the Federal Reserve.

We strongly support provisions which would both end promptly the prohibition against payment of interest on business checking accounts, and allow the Federal Reserve to pay interest on depository institutions balances required to be held on reserve at the Federal Reserve. Delaying the removal of the prohibition is an unsatisfactory bandaid approach which merely stalls the march toward modernization of our financial services system through the elimination of anti-competitive regulatory devices like Regulation Q.

Congressional legislation passed in 1933 prohibited banks from paying interest on demand deposits and was implemented by the Federal Reserve as Regulation Q. Most of these restrictions were removed early in the 1980s, but a painful vestige remains in the prohibition of interests on demand deposits held by businesses.

For most of AFP's membership, Regulation Q has become an annoying anachronism. Earnings on balances can for the most part be managed through other types of accounts and transfers made possible with current technology and willing competitors to commercial banks. The practical effect of Regulation Q today is that it has spawned a myriad of demand deposit substitutes which obviate the long obsoleted intention of the Banking Act of 1933. Many smaller businesses however still suffer the effects of Regulation Q because of lack of sophistication, access to technology and/or insufficient deposit balances. Even large businesses which use innovative procedures to employ balances profitably would benefit from the flexibility and simplicity in funds management which would follow from payment of interest on demand deposits accounts (DDAs).

Cash management would be simplified for all businesses and banks through abolition of the ban on paying interest on business checking.

Allied with the Regulation Q problem is the rapid decline of required reserves held at the Federal Reserve. Just as commercial customers have incentives to move balances from DDAs to interest-bearing accounts outside the banking structure, so do banks have incentives to move DDAs subject to reserve requirements. As a result, required reserve balances at the Federal Reserve have plummeted in recent years. The Federal Reserve reports that reserve balances are critical to management of monetary policy. The Fed uses the markets for overnight loans of reserve balances to influence other interest rates. The smaller this market, the greater difficulty the Central Bank has in stabilizing or managing rates. Part of the cure for this problem would be to allow interest to be paid on required reserves.

Before the Banking Act of 1933 was passed, banks regularly paid interest on DDAs. Then, in the wake of more than 9,000 bank failures between 1930 and 1933, Congress passed the Banking Act to limit banks' service options and to protect them from competition. Among other measures included in the Act, a provision (implemented as Regulation Q) prohibited payment of interest to corporations on their demand deposit account balances to keep banks, in the heat of competition, from offering interest levels on deposit balances that might be sustained through risky investments.

Today, of course, banking is much different. Interest-bearing checking accounts for individuals have been allowed since 1980. Many of the services traditionally controlled by banks—checking account services among them—are now being provided by non-banks, which are not subject to restrictive banking regulations. Meanwhile, faced with a prohibition against earning interest on DDAs balances, savvy treasury professionals utilize innovative procedures to sweep those funds into money market and other instruments often held outside the banking system.

Regulation Q should be abolished on the basis of its obsolescence alone. But there are other reasons as well. For one thing, reliance on the "work-arounds" that Regulation Q has spawned puts smaller banks and bank customers at a competitive disadvantage because they lack

the sophistication, access to technology, or required balances to utilize sweep accounts. And even those businesses that already use these “work-arounds” would benefit from the flexibility and simplicity in funds management that payment of interest on DDAs would afford.

Examples of the “Work-arounds” employed by corporations include:

- Earnings Credits — Banks calculate how much the collected balances in checking accounts would have earned if interest could have been paid. This amount is then subtracted from the fees owed by the company for the services that the bank provides.
- Controlled Disbursements — Banks notify the corporate customer by mid-morning of the dollar amount of checks that will clear against its account that day. The company then invests all available funds each day. Aggressive cash managers move funds out of banks and into interest-bearing vehicles managed by non-bank competitors, which face no restraints on their investment offerings.
- Sweep Accounts — Sweep accounts transfer funds automatically, in excess of a pre-determined balance, from a customer’s demand deposit account into an interest earning account or short-term investment. Funds are “swept” into any of several investment options. In effect, a sweep is a service which automatically links a deposit account with an investment or earnings account. The most common investment/earnings accounts are:
 - Depository accounts such as Money Market Deposit Accounts (MMDA);
 - Money market mutual funds—both bank proprietary and third party funds;
 - Offshore instruments such as deposits in affiliates of U.S. banks;
 - Overnight instruments such as repurchase agreements of U.S. Treasuries, commercial paper, and Fed funds.

Sweep account asset growth during 1998-1999 period was 19% for all instruments to \$220 billion.¹

Historically, banks offered commercial sweep investment programs as a defensive tactic against money market mutual funds and other devices which were disintermediating bank deposits. Now, many banks have become aggressive in the marketing of sweeps, even for

¹ 2000 Commercial banking Sweep Account Survey, Treasury Strategies, Chicago Illinois.

individual consumer accounts, since the apparent benefits to banks from offering sweep accounts appear to be compelling:

- Revenue — The average annual total revenue per account ranges from \$3,700 to more than \$18,000.²
- No Interest Expense — In lieu of interest for DDAs, banks earn substantial fees as shown above.
- Reduced bank reserves — Sweeps move customer funds off balance sheets, and reserves on those deposits are eliminated.
- Recapture of lost assets — Most sweeps are now made directly into bank proprietary money market mutual funds. A sweep product provides an opportunity for customers to consolidate investments and accounts at the bank.

The benefits are misleading however, and the advantages to the banks' rising sweeps revenues may be short-lived. Demand deposits are still declining and now constitute only 12% of total deposits, and 8% of total bank liabilities—down from 33% and 30%, respectively, only 20 years ago. This translates into DDAs seeking value outside banks, and the increasing need for banks to fund through borrowing. We find it ironic that the banking industry is currently saying it is having difficulty finding sufficient deposits to support its lending activities yet continues to move deposits out of the banks. In addition, while banks decry the loss of deposits, many seek an increase in deposit insurance coverage from \$100,000 to \$200,000 per account as a competitive edge to attract deposits.

The bottom line is that federal regulation drawn from depression-era protective legislation creates an artificial market environment that provides benefits which may be short-term to bank participants. Large and middle market companies are generally able to escape sterile balances resulting from the ban on interest for DDAs. Smaller companies often miss opportunities provided by sweeps because “most competitive overnight instruments require minimum denominations that are out of reach for most small companies.”³ Also, many smaller financial institutions lack the scale and resources to provide sweeps products.

Often overlooked as a casualty of the interest ban is the “residue” balance remaining in DDAs which utilize sweep services. These cumulative balances are substantial and fail to earn value. So in fact bank customers of all sizes are disadvantaged by Regulation Q. A free market scenario should present sweep and interest-on-deposit options to all bank customers and banks.

² 2000 Commercial Banking Sweep Account Survey Results, Treasury Strategies, Inc., Chicago Illinois.

³ 1997 Commercial Banking Sweep Account Survey Results, Treasury Strategies, Inc., Chicago, Illinois.

Ending this archaic regulatory device will not terminate aggressive cash management tools like sweeps. But the end of Regulation Q will terminate the artificial environment which created the sweeps market. Products should not owe their existence to government protection through price regulation (i.e., no interest on business checking accounts). Rather, they need to demonstrate their worth in a free market as another option a customer may choose.

Finally, it is because of the interest expense that banks would incur following elimination of Regulation Q that some are supporting a delaying tactic, which keeps Regulation Q intact but creates yet another loophole. This plan would expand to 24 (from six) the number of times a company can withdraw funds from money market deposit accounts each month. Through daily transfers from interest-bearing accounts to cover checks drawn against DDAs, a bank gives its corporate clients, to some degree, checking account interest. The plan does not address a common problem for many corporate customers: they cannot anticipate all funding needs, and frequently would require multiple daily transfers from the money market deposit account—not permitted under this juryrigged approach.

This proposed plan does provide somewhat more flexibility in enabling customers to utilize idle funds. However, it does not simplify the customer's cash management procedures, address the dwindling Fed reserve issue, nor the outflow of funds from banks. And it ties the banks' hands as well. Without Regulation Q, banks have the freedom to develop products, with or without an interest component.

In a letter released February 20, 1998, Federal Reserve Board Chairman Greenspan criticized this plan: "The Board supports the elimination of unnecessary or anti-competitive regulatory requirements. A 24-transaction account might aid banks in meeting competition but the Board believes that a more straightforward and more economically efficient way to address this issue would be simply to repeal the prohibition against the payment of interest on DDAs."

A Senior Financial Officer Survey conducted by the Federal Reserve in May 1998, made a telling point which concerned the impact on banks of paying interest on business checking. That survey reflected the opinions of senior financial officers of 44 large commercial banks:

"In summary, it seems that banks would incur a short-term increase in costs if they were allowed to pay interest on DDAs. The extent of this increase, however, would probably be muted considerably by a tiered-deposit rate schedule and by the fact that a substantial proportion of DDAs already earn implicit interest. In the long run, the effects of allowing banks to pay interest on DDAs would almost certainly be salutary by removing a significant regulatory distortion and by encouraging increased competition and efficiency in the banking industry."

Some banking groups argue that implementation of systems and procedures to provide for business checking interest would be a difficult and costly process, requiring several years for the transition. Since banks are in the business of calculating interest, and in fact compute earnings credit for business accounts now, we believe that the transition would be relatively easy, and require no more than 90 days.

We support the changes discussed in this statement because they solve some fundamental problems for bank customers, banks, and the Federal Reserve. The inability of depository institutions to pay interests on business accounts hurts all sectors of the economy but especially small businesses. Some banks have convoluted arrangements to sweep sterile checking account funds on a daily basis to money market deposit accounts or other earnings instruments. The “sweep” systems in connection with controlled disbursement services are cumbersome and costly for smaller banks and savings institutions to operate. This impedes the ability of smaller depository institutions to compete for business checking accounts and for small businesses to obtain the benefits of productive use of funds often available to larger and more sophisticated businesses. However, even large businesses which have developed means to employ balances profitably would welcome the flexibility and simplicity in funds management which would follow the elimination of Regulation Q.